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An Argument for the Tight Spread, Elevated Yield Environment

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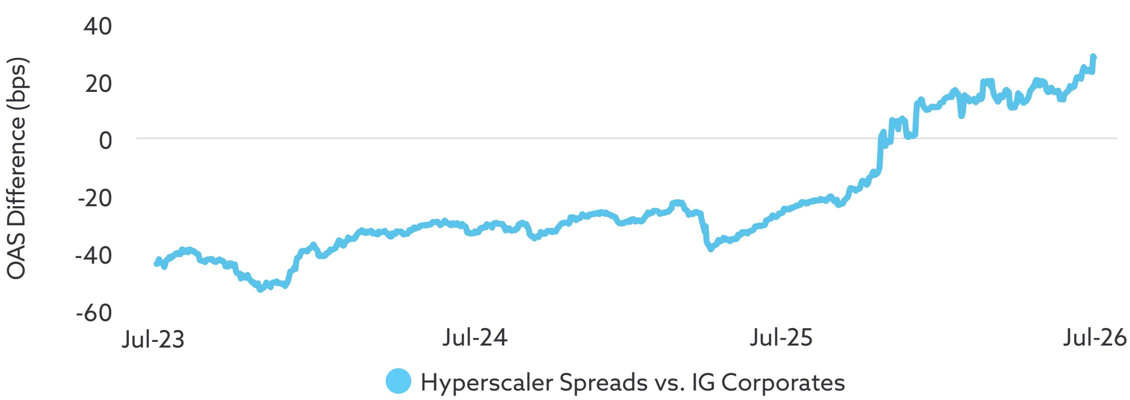
The US corporate bond market has been marked by both tight spreads and elevated yields recently, an unusual situation after many years of low yields. Despite market concerns that spreads may be too tight given prevailing risks, we believe the current relationship between spreads and yields is generally where it should be.

Yields on US Treasuries currently make up 83% of the all-in yields of the US investment grade corporate bond market, compared to a 15-year average of 61%.[1] Typically, Treasury yields should reflect the market's views on the risks of lending to the US sovereign, among other factors. The US federal government is in a deteriorating fiscal situation today, running a historically high deficit with a rising interest burden. In our view, the political establishment has given little indication that it is likely to do anything to materially address the problem. As a result, the market has priced Treasury yields higher, especially for longer durations.

On the other hand, US corporations are generally improving their profitability and credit quality. Ironically, federal spending could be one driver of the improvement in corporate profitability. The improvement in earnings is also broad-based, as evidenced by the outperformance of the Russell 2000 versus the S&P 500 since the middle of Q4 2025.[2] We would note that since May 2025, the federal government's credit rating has been AA at all three rating agencies, while corporate ratings have trended upward (toward single A in investment grade and BB in high yield). As the sovereign deteriorates while corporates improve, this convergence in credit quality may result in tighter spreads, all things being equal, which is consistent with what is happening in fixed income markets.

One sector where spreads have bucked the tightening trend is in Technology, where a deluge of AI-related bond issuance has pushed select sub-sectors wider. While impacting many markets (e.g., global IG, US HY and structured), US investment grade corporates have been more materially impacted. The substantial increase in new issuance has weighed on valuations, with hyperscaler credit spreads underperforming the broader investment grade market by roughly 70 bps over the past five quarters.[3]

HYPERSCALER SPREADS HAVE WIDENED SIGNIFICANTLY[3]



As of 23 July 2026. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (1) FactSet. As of 30 June 2026. Yields of the 7-year US Treasury and the ICE BofA US Corporate Index. The 7-year Treasury is used because it is closest to the duration of the index (~6.4 years). (2) FactSet. As of 30 June 2026.(3) ICE Data Services. Daily data through 8 July 2026. Index is the ICE BofA US Corporate Bond Index. Hyperscalers are Amazon, Alphabet (Google), Microsoft, Meta, Oracle, Nvidia and SpaceX.

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Does the significant widening in the Tech sector represent a potential opportunity to generate alpha? Or is it a value trap? To address these questions, we compare this period of AI-related bond issuance to previous situations where the US corporate bond market experienced a material uptick in issuance.

- A COVID-induced spike initially led to spread widening in March 2020, as existing bonds repriced wider to match new issuance. However, even with continued issuance, spreads tightened in Q2 2020 amid an overall market rebound.[4]
- The Financial sector has developed a post-COVID trend, from our observations, where banks and other firms issue so much in January that a new monthly issuance record has been set every year since 2022 (2026 surpassed 2025, which surpassed 2024, etc.). However, the market has learned to anticipate the issuance surge and financial sector spreads have tightened in Januarys since 2023, aided by the fact that financial supply ebbs over the remainder of each year.[4]

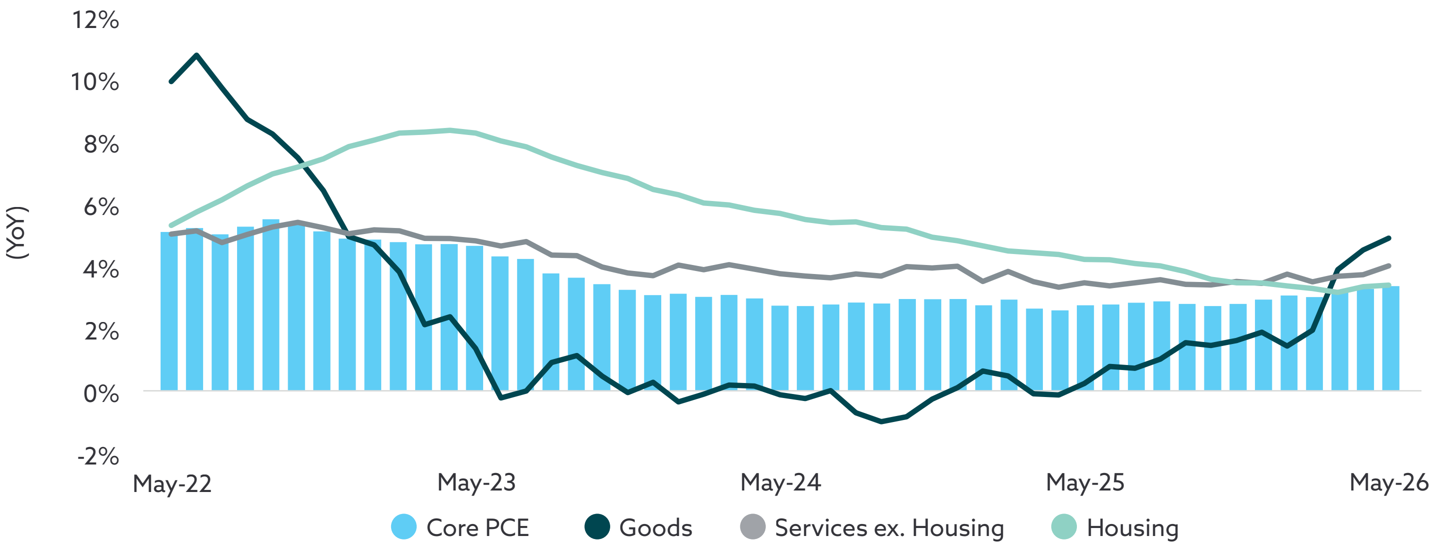
In our opinion, AI-related issuance is different from these prior examples in that the market has not previously seen a supply increase of this magnitude. Large investment grade offerings from hyperscalers ($20B+) have had to come at wider spreads in order to clear the market and, in the process, have also repriced existing bonds in the AI space wider. Given the capex plans of these hyperscalers, the supply appears to be open ended, unlike previous issuance surges that had more clarity on their timelines. As a result, we do not expect AI-related spreads to tighten in the medium term. Although they could level out tactically for a while, further spread widening may be likely, especially if issuance volumes perdure.

Having said this, there may be opportunities for investors to outperform over the longer-term by selectively owning hyperscalers. In our view, the recent widening is driven primarily by technical rather than fundamental factors, reflecting the market's need to absorb unprecedented supply rather than deterioration in credit quality. We believe the sector may offer an attractive investment opportunity if issuance abates or becomes better understood by the markets, especially given our view that these companies are positioned to maintain their existing strong credit profiles.

Returning to the yield question, the curve flattened in Q2 2026 as markets priced in the possibility of Fed hikes over the next 12 months, driven by concerns about higher inflation.[5] Just as the deficit has underpinned higher long-end Treasury yields, an expected slightly higher rate path from the Fed has increased short-end yields.

One reason is that inflation, as measured by headline CPI, is elevated right now, partly driven by the run up in energy prices. From our review of history, quick retracements of oil prices following spikes, as already witnessed in May and June on US-Iran ceasefire talks, have also led to quick declines in headline CPI.[5] This dynamic was on full display in June's CPI reading.[6]

TARIFFS, AI BUILD-OUT HAVE DRIVEN GOODS INFLATION HIGHER[7]



(4) Barclays, ICE Data Services. 1 and 7 July 2026. (5) FactSet. As of 30 June 2026. (6) US Bureau of Labor Statistics. 14 July 2026. (7) FactSet. As of May 2026, the latest data available.

Energy prices have not been the only driver of higher inflation. When looking at the goods inflation component of the PCE price index, it bottomed in Q3 2024 and has been trending higher since, including a spike in recent months.[7] These figures, calculated year-over-year, are likely manifesting the delayed impact of tariffs on prices. Tariff rates have come down but are likely to remain well above historical levels. But rising goods inflation is also due to sharp price increases for some inputs related to the AI build-out. These are unlikely to subside anytime soon, especially if the AI capex build-out continues as discussed above.

Putting all this together, we expect headline inflation to subside from here, driven by lower oil prices, subject to developments in the US-Iran conflict. On the other hand, core inflation may not decline as much, bolstered by AI-linked inflationary pressure. Given the uncertainty related to inflation, we believe that the market-implied pricing of Fed actions is reasonable, with a couple of hikes (but no aggressive hiking cycle) priced in over the next few quarters.

Given we do not currently see an aggressive hiking cycle by the Fed, we believe risk markets are in an appropriate place. It is understandable that many investors are negative on markets due to tight spreads, geopolitical risks, AI concerns, elevated inflation and private credit concerns. However, we believe the fundamental picture remains a tailwind, especially at the corporate level where companies are benefitting from fiscal spending, a resilient consumer, pricing power and historically high margins. Furthermore, inflows are likely to continue into the US fixed income market given elevated yields, supporting performance.

Our view is the market is unlikely to sell off significantly, though it could experience pullbacks that are met by increased demand (i.e., the "buy-the-dip" mentality). Our client portfolios generally hold modest overweights versus benchmarks, reflecting strong corporate fundamentals and what we consider attractive yields. Our goal is to be up-in-quality in portfolios while generating positive carry. We lean into our credit research team to inform decisions on bonds that meet those two criteria. Credit research can also inform tactical opportunities in case of a market pullback, or if valuation dislocation creates opportunities among hyperscalers.

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